

**SUMMARY OF THE REGULAR MEETING OF THE
ARIZONA STATE RETIREMENT SYSTEM
INVESTMENT COMMITTEE**

**HELD ON
Tuesday, July 10, 2007
3:30 p.m., MST**

The Investment Committee (IC) of the Arizona State Retirement System (ASRS) met at 3300 N. Central Avenue, 14th Floor Conference Room, Phoenix, Arizona 85012. Mr. Lawrence Trachtenberg, Chairperson of the IC, called the meeting to order at 3:32 p.m., MST.

The meeting was teleconferenced to the ASRS Tucson office, 7660 East Broadway Boulevard, Suite 108, Tucson, Arizona 85710.

1. Call to Order; Roll Call; Opening Remarks

Present: Mr. Lawrence Trachtenberg, Chair
Mr. Christopher Harris
Mr. Thomas Connelly

Absent: Mr. James McLaughlin

A quorum was present for the purpose of conducting business.

2. Presentation, Discussion, and Appropriate Action Regarding the ASRS Private Equity Program

Mr. Paul Matson, Director, stated that in October 2006, the Board approved a five percent (5% +/-2%) target policy allocation to institutional private equity. Subsequently, Mr. Richard Henkel, Private Equity Portfolio Manager was hired. Richard, along with the Director, Chief Investment Officer (CIO), and Ennis Knupp (private equity consultant) developed the ASRS Investment Policy and Strategic Plan which identifies the investment philosophy, objectives and policies, long-term program performance expectations and other matters which will govern the management of the ASRS private equity program.

Mr. Matson explained the two components of the Private Equity Committee (PEC), which are the membership and the functionality. The PEC is to be composed of the Director, CIO, the Investment Management Division (IMD) Private Equity Portfolio Manager, ASRS' private equity consultant(s), and one or two IC trustee(s). The latter two parties will be non-voting. The PEC functions include:

1. Program Oversight/Implementation which includes:
 - Authorizes development, execution, termination of contracts,
 - Hiring/termination of PE Legal Counsel,
 - Hiring/termination of PE consultant(s).

2. Approval of sub-strategies tactical allocations.
3. Director/CIO recommends to the IC or Board strategic changes to the PE Investment Policy and Strategic Plan.
4. Oversee PE program procedural and implementations processes.

Discussion ensued regarding the PEC's ability to retain legal counsel in a timely manner, avoiding delays such as experienced in the Real Estate Program. Mr. Henkel said that Ennis' legal counsel is available for use while awaiting response to an RFP that may be issued to retain legal counsel.

Mr. Matson said that the ASRS will use a variety of investment vehicles including primary partnership, secondary funds, primary Fund-of-Funds, Fund-of-Funds separate accounts, co-investments and direct placements, and joint ventures. He noted that the ASRS will use diversification as a risk mitigation tactic. Relevant risk factors considered are strategy, manager, firm, vintage year, industry, geographic and liquidity issues.

Mr. Harris stated that he has served on the Real Estate Committee (REC), and it is a very efficient way to move through the process of making these types of investments. He supports the idea of the PEC working in the same manner. He asked if the trustee(s) on the PEC were to vote, would they represent the Board. Mr. Thomas I. McClory, Assistant Attorney General, said such a vote would only represent the person as an individual on the PEC and not a Board Committee. The PE will have the authority to hire and terminate private equity managers.

On the REC, the participating trustee(s) does not vote due to governance issues. The idea was that a voting trustee could not oversee his earlier vote, if/when the matter went to the Board. The selection of PE voting members was generally based on the notion to separate the decision-making from the program oversight function. Additionally, the PEC may be required to make decisions on time sensitive private equity deals and other related matters; the ASRS did not want to require that of trustee(s).

Mr. Connelly inquired about deal selection and Mr. Henkel stated that any deal considered must make business sense. In general, the ASRS will stay out of socially-motivated private equity deals.

Motion: Mr. Connelly moved to recommend to the Board approval of the ASRS Private Equity Program Investment Policy & Strategic Plan.

Mr. Harris seconded the motion.

By a vote of 3 in favor, 0 opposed, and 1 absent, the motion was approved.

3. Presentation and Discussion Regarding Credit Default Swaps (CDS)

Mr. Gary R. Dokes, Chief Investment Officer (CIO), introduced the topic. The use of CDS by the ASRS will be predicated on establishing internal and external fixed income manager

guidelines, modifying operational reporting and oversight procedures and obtaining final approval by the CIO and Director.

Mr. Dokes noted that a CDS is an over-the-counter contract between two parties which transfers the credit risk of a reference entity (corporate bond issuer) from the buyer of protection to the seller. The buyer of protection is said to be “short the credit” and is reducing credit risk. The seller of protection is said to be “long the credit” and is taking on credit risk. Credit Default Index (CDX) is a type of CDS based on a standardized basket of credit default swaps. Current size of the CDS Market is estimated to be \$30-\$40 trillion in notional value. Participants include banks, insurance companies, hedge funds, asset managers, and pension funds. Risk premium can be dissected into two (2) parts: swap spread and credit spread. Swap spreads represent the general market spread which denotes the risk associated with investing in non-treasury securities; credit spreads relate to company-specific risks (default, LBO, bankruptcy, etc.). CDS enables a portfolio manager to better manage credit spread risk.

Mr. Thomas Williams, Fixed Income Portfolio Manager, explained various credit events which would trigger action/termination of CDS. These are bankruptcy, failure to pay, and debt restructuring. He outlined how a trade would take place, how it could be terminated, and the physical or cash settlement if a credit event occurred.

Discussion ensued regarding liquidity in the CDS market.

Mr. Dokes said that potential ASRS usage of CDs would be:

- Hedge exposure to single name credit risk (CDS)
- Reduce/increase overall portfolio credit exposure (CDX)
- Take single name credit exposure (CDS)
- Basis trades (buy cash/buy CDS) (ASRS external fixed income managers only)

Mr. Dokes stated that the ASRS would complete International Swaps & Derivatives Association documentation with each counterparty and establish internal/external manager guidelines for CDS usage. Then, the ASRS will engage the ASRS Custodian Bank, the ASRS accounting department, and internal and external audit groups to establish settlement procedures and ensure accurate recordkeeping of CDS contract exposure.

4. Presentation and Discussion Regarding ASRS Total Fund Performance Attribution Reporting

Mr. Dokes introduced the topic. The IMD has enhanced the Quarterly Total Fund Attribution report to improve readability, clarify the footnotes, and ensure the logical flow of information. These attribution reports are generated quarterly by the IMD and are included in the Director’s Report to the Board to complement the official Arizona State Retirement System (ASRS) Total Fund performance reports, which are presented by Mercer each quarter.

Mr. Dokes pointed out that Page 1 of the attribution analysis is a quantitative analysis that decomposes total fund excess return, or management effect, in three effects: 1) strategic asset allocation, 2) tactical asset allocation, and 3) net manager selection.

Mr. Dan Kapanak, Manager of Investment Strategy, explained that Page 2 of the analysis identifies which asset classes, style tilts, and managers made significant contributions to total fund excess return. Discussion ensued regarding allocation effect.

Mr. Dokes said this is a high level document that is appropriate for the Board to review. Mr. Matson stated that this is a great reporting platform upon which IMD is building.

5. Presentation and Discussion Regarding the Asset Allocation and Rebalancing Policies and Procedures for the ASRS Plan and Long Term Disability (LTD) Program

Mr. Lawrence Trachtenberg introduced the topic. Mr. Dokes said this issue will be discussed during the Board's September Strategic Planning Session. He said this is mainly a housekeeping issue which needs clarification. The existing asset allocation policy and procedure is being replaced with four new policies, two for the ASRS Plan and two for the LTD Program. He mentioned some highlights of the new policies. Discussion ensued regarding fund rebalancing.

Motion: Mr. Connelly moved that the IC approve and recommend to the Board approval of the Asset Allocation and Rebalancing Policies and Procedures for the ASRS Plan and LTD Programs.

Mr. Harris seconded the motion.

By a vote of 3 in favor, 0 opposed, and 1 absent, the motion was approved.

6. Future IC Agenda Topics

None.

7. Call to the Public

No members of the public requested to speak to the IC.

The meeting adjourned at 4:49 PM.

Respectfully submitted,

Lisa Hanneman, Secretary

Date

Gary R. Dokes, Chief Investment Officer Date